MCI Telecommunications Corporation
1801 Pennsylvania Avenue, NW
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FEDERAL COMMUNICATIONS COMMISSION
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September 28, 1992

Ms. Donna Searcy
Secretary
Federal Communication Commission
Room 222
1919 M Street, N.W.
Washington, D.C. 20554

Re: In the Matter of: Regulatory Reform For Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket No. 92-135.

Dear Ms. Searcy,

Enclosed herewith for filing are the original and eleven (11) copies of MCI Telecommunications Corporation's Reply Comments in the above reference matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of MCI's Petition, furnished for such purpose and remit same to the bearer.

Yours truly,

Gregory J. Darnell
Manager, Regulatory Analysis

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SEP 28 1992

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
	)	
Regulatory Reform for	)	CC Docket No. 92-135
Local Exchange Carriers	)	
Subject to Rate of Return	)	
Regulation	)	

REPLY COMMENTS OF MCI TELECOMMUNICATIONS CORPORATION

Gregory J. Darnell
Manager, Regulatory Analysis
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(202) 887-3290

Dated: September 28, 1992

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SUMMARY

MCI generally supports the Commission's efforts in this proceeding to improve efficiency, streamline tariffs and decrease administrative burdens for the small LECs that remain under rate-of-return regulation. MCI opposes the Comments of many of the LECs filed in this proceeding.

Noting that the risk/reward relationship may have contributed to the decision of certain LECs not to adopt price caps, the Commission in its OIR plan has proposed to sweeten the pot. However, the Commission's proposal is overly generous. Particularly in light of the small LECs existing ability to manipulate earnings and the general lack of competition with exists in their markets. Therefore, certain modifications are required to balance the risk/reward relationship offered under the OIR plan. Moreover, no additional rewards should be blindly added.

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REPLY COMMENTS OF MCI TELECOMMUNICATIONS CORPORATION

Pursuant to the Commission's Notice of Proposed Rulemaking (NPRM), released July 17, 1992 in the above referenced matter,[1] MCI Telecommunications Corporation (MCI) hereby submits reply comments to the comments filed by various parties on the proposed regulatory reform for Local Exchange Carriers (LECs) subject to rate of return regulation.[2]

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[1] In the Matter of Regulatory Reform for Local Exchange Carriers Subject to Rate of Return Regulation, Notice of Proposed Rulemaking, CC Docket No. 92-135, released July 17, 1992 (Notice).

[2] In the Matter of Regulatory Reforms for Local Exchange Carriers Subject to Rate of Return Regulation, CC Docket 92-135, Comments of: National Exchange Carrier Association (NECA); Tallon, Cheeseman and Associates, Inc. (TCA); United States Telephone Association (USTA); National Telephone Cooperative Association (NTCA); Ronan Telephone Company (Ronan); Taconic Telephone Corporation (Taconic), John Staurulakis, Inc. (JSI); Central Telephone Company (Centel); Independent Telephone Access Group (ITAG); The National Association of Regulatory Utility Commissioners (NARUC); Chief Counsel for Advocacy of the United States Small Business Administration (SBA); Alltel Service Corporation (Alltel); Puerto Rico Telephone Company (PRTC); Lincoln Telephone and Telegraph Company (Lincoln); PTI Communications (PTIC); Cincinnati Bell Telephone (CBT); GVNW, Inc./Management (GVNW); American Telephone and Telegraph (AT&T); and, The Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO) (The Commentors).

I. INTRODUCTION

As addressed in its Comments, MCI has identifiable but surmountable concerns with the Commission's Proposal on Regulatory Reform for Local Exchange Carriers (LECs) Subject to Rate of Return Regulation. MCI's concerns were focused on the need to limit the level of pricing flexibility provided to these LECs to no more than that provided under price caps and the fact that no incentive regulatory plan for these LECs will achieve the desired efficiency results until the Universal Service Fund is capped. While MCI maintains these objections, the Comments contributed by many of the small LECs and their associations evoke major additional concerns.

II. DISCUSSION

A. Optional Incentive Regulation Reply Comments

1. LECs Must Not Be Permitted to Elect Optional Incentive Regulation For Depooled Traffic Sensitive Rates If They Have Not Depooled Their Common Line Rates

The Commission stated that in order to "maximize the benefits of an incentive plan, the company's total regulated interstate operations should be subject to the plan" and tentatively concluded that companies electing the incentive plan develop and maintain both common line and traffic sensitive (TS) rates within the incentive plan.[3] The Commission sought comment on this proposal and requested that parties urging

[3] Notice, ¶ 24.

adoption of a bifurcated approach (e.g. allowing participation for TS rates only) should provide data and information supporting their views.[4]

Some of the commentors in this proceeding urge the Commission to adopt a bifurcated approach to the optional incentive regulation (OIR) plan.[5] The Commentors generally argue that absent the security of the NECA Common Line pools the risks would be too large to enter into the Commission OIR plan. However, none of the commentors have complied with the Commission's request to provide data or information supporting their views.

The Commission is correct in its assessment that in order to maximize the benefits of an incentive plan, the company's total regulated interstate operations should be subject to the plan. One of the reasons that this is true, is that a bifurcated approach would open yet another avenue by which the LEC's could manipulate of earnings and evade regulatory constraints.

The final word in utility regulation is the control on the reported rate of return and the mechanisms which are created to refund overcharges to customers. Bifurcated implementation of the Commission's OIR would create an incentive for the small LECs to maximize total earnings through accounting manipulations of earnings between the Common Line pool and the high end of the Traffic Sensitive earnings band. If bifurcation is permitted, the small LECs would have a financial incentive to report investments, expenses, reserves and revenues in a manner which would generate a traffic sensitive

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4 Ibid.

5 GVNW, p. 5, PTI, p. 4, Alltel, p. 7, SBA, p. 9, TCA, p. 7, USTA, p. 5, JSI, p. 9, ITAG, p. 7.

rate of return equal to the high end of the TS earnings band and if Common Line earnings suffer, the pooling process would "correct" these mythical earning deficiencies in the following year. This is merely an opportunity for these LECs to increase total earnings without increasing efficiency. Therefore, if bifurcation is permitted it would be difficult to evaluate the effectiveness of the OIR plan, and any perceived benefits of the OIR plan would be questionable. In light of the Commission's efforts to reduce burdensome regulations and to create true efficiency, not incentives to manipulate accounting, bifurcation of the OIR plan would not be in the best interest of the industry or this Commission.

2. Optional Incentive Regulation Must Provide Balanced Incentives and Risks for the Implementation of LEC Efficiencies

Alltel argues that the Commission has mistakenly assumed that rate of return companies have not elected to be regulated under price caps because they are adverse to the so-called heightened risks of a price cap system.[6] Alltel submits that it is not an aversion to heightened risk that precludes the election of price caps by many rate of return companies, but the diversity of size, cost and usage characteristics require many of these companies to participate in pooling arrangements and the Commission rules require all or nothing participation.[7]

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[6] Alltel, p. 3.

[7] <u>Ibid</u>.

MCI submits that the diversity of size, cost and usage characteristics identified by Alltel that require these companies to participate in pooling arrangements are, in fact, elements of risk and that the risk inherent in incentive regulation plans is what provides the LECs the incentive to become more efficient. If the risk is removed so is the efficiency incentive. Alltel is arguing that it should be able to assume no risk, by being permitted to stay in the NECA pools, and participate in the earning incentives of the OIR plan. Therefore, Alltel is simply asking for the opportunity to make more money without assuming any additional risk. This would in no way enhance efficiency and is not incentive regulation.

Many of the small LEC commentors request that the earnings zone be increased from 100 basis points to 200 basis points.[8] However, no LEC has provided any data to support or in any way show that the level of risk inherent in the OIR justifies increasing the level of reward. Therefore, the Commission should not blindly expand earnings zones.

The existing Price Cap "Structure" does not necessarily need to be changed to accommodate the small LECs. As recognized by the Commission, all that needs to be evaluated is the appropriate level of risk and reward.[9] This is done in the existing Price Cap structure through earnings bands and productivity factors. Under Price Caps, the amount of earnings risk a LEC faces is related to the potential level of earnings. This can

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[8] GVNW, p. 2, CBTC, p. 3, Lincoln, p. 5, PRTC, p. 7, USTA, p. 16, JSI, p. 5, Centel, p. 5 and ITAG, p. 6.

[9] See, Second Report and Order, 5 FCC Rcd 6786, 6782 (1990).

be accomplished in the OIR plan by establishing specific productivity factors, based on the level of risk for LECs, or categories of LECs, given constant earning bands.

When the FCC developed the Price Caps productivity factors and earning bands it assumed that all LECs encounter relatively equal earning risk. As shown by the decision of some carriers that failed to opt for Price Caps, this may not have been a wholly accurate assumption. What is now assumed to be true is that the smaller and less diverse a LEC's customer base is, the less confidence it will have that it will meet or beat the Commission's established productivity indices. Therefore, the key element in this equation is the standard variance from the mean of the LECs long run productivity.

The risk/reward relationship can be illustrated in the following: Lets assume that when the commission determined its price cap risk/reward relationships, the following confidence intervals were associated with the large LECs' productivity: 95% confident of 2.3% productivity; 80% confident of 3.3% productivity; 65% confident of 4.3% productivity; 50% confident of 5.3% productivity; and so on . . . . In this hypothetical, the level of risk can be used to determine the reward (i.e. 80 percent earnings confidence could receive a reward up to a 200 basis point earning band and 65 percent earnings confidence could receive a reward of up to 300 basis point earning band).

Therefore, a long term productivity factor continuum, given certain specific characteristics of each LEC or group of LECs, should be calculated. While customer diversity and size may be two of these characteristics, careful evaluation of the specific characteristics must be undertaken so that a reasonable calculation of risk can be made.

Although it fails to back up its contention with data, NTCA argues that this cannot be **effectively** calculated.[10] MCI argues that NTCA has confused calculation and implementation. While this has not yet been evaluated, NTCA may be correct that implementation of this process may not be compatible with the structure of certain small LECs. This would be true if the standard variance from the mean productivity of the small LEC was significant and if the LEC did not have the management skills or resources to request appropriate exogenous changes to their proposed rates and mid-course revenue requirement corrections as required. The Commission has prudently proposed to provide OIR LECs the option of arguing for exogenous Price Cap Index changes and mid-course corrections as compensation for aberrant occurrences in LEC productivity (i.e. occurrences which lie far outside the standard variance from the mean of the LECs long term productivity). Therefore, NTCA's concerns appear to involve the management skills and the resources of certain small LECs because the concerns of potentially confiscatory rates has been adequately addressed by the Commission. This potential implementation problem should not be used an excuse not to calculate the risk characteristics of the LECs.

The Commission, in its OIR, goes one step further and proposes to permit small LECs to include "Known and Measurable" changes in their going forward indices. As demonstrated by AT&T, this is a overly generous limitation on risk and should not be permitted.[11]

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[10] NTCA, p. 4.

[11] AT&T, p. 5.

The Commission should therefore, undertake an in-depth analysis in an attempt to ascertain the small LECs' long term productivity and place certain categories of LECs in specific risk/reward incentive regulation plans. The only difference between the current Price Caps plan and the OIR plan would be that each LEC, or category of LEC, would have a custom designed long term productivity factor. Once this process is completed, the current Price Cap structure could be mandatorily applied to all LECs that are identified as having a sufficient management skills and resources to accept additional risks. In the end, it may be found that incentive regulation plans are not reasonably compatible with the characteristics of certain small LECs. It may also be found that incentive regulation plans are more compatible with certain small LECs and that the reason the small LECs have not selected Price Caps has nothing to do with risk, but rather is because these carriers currently receive a better deal through NECA and their pooling arrangements.

3. Pricing Flexibility Should Not Incorporate A Rate Adjustment Factor at the End of Each Two-Year Incentive Regulation Period

The Commission proposes a pricing flexibility feature as part of OIR that would include a "basket" and "service category" system similar to that of price caps.[12] Under the OIR, within each two year period, aggregate rates for each basket must remain unchanged, but LECs may adjust rates within each service category by no more than 10

[12] Notice, ¶ 18.

percent during the period.[13] At the end of the two year incentive period, rates are trued up back to costs.

Certain Commentors have argued that OIR LECs should be provided pricing flexibility similar to that provided under price caps.[14] Under Price Caps, LECs are provided additional pricing flexibility through an ability to compound their pricing flexibility every tariff period and move rates further and further from costs each tariff period. The Commission did not propose to provide OIR LECs this compounding of pricing flexibility. These commentors request that the Commission modify its OIR proposal to permit OIR LECs to compound pricing flexibility by maintaining the rate relationship created by pricing flexibility during each biennial review and adjusting these rate through the use of overall percent changes or Rate Adjustment Factors (RAFs).

The Commission was reasonable in this action to propose pricing flexibility for OIR LECs that is less than Price Cap pricing flexibility. This action is reasonable because in general, the small LECs are monopolists and have not shown that they even face the very limited competitive pressures that some large LECs face and, therefore, could use the pricing flexibility provided under Price Caps to charge unreasonable rates to certain customers. Therefore, the Commission should not modify its proposed Pricing Flexibility provisions for OIR.

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[13] As shown by MCI in its Comments in this proceeding this provision should be limited to 5 percent changes annually, Comments of MCI Telecommunications Corporation, CC Docket 92-135, August 28, 1992, p. 3.

[14] USTA, p. 17 and USTA, p. 12.

4. The New Service Rule Should Require a Cost Based Filing After 12 Months of Experience

The Commission has proposed that "[A]t the end of twelve months, the carrier must calculate rates for the new service based upon the historical costs for that service."[15] USTA and JSI argue that as long as a LEC proves that the revenue it receives is de minimis, the FCC should not require a cost based filing.[16]

USTA and JSI miss the point. The issue is not whether the new service rates are hurting the small LEC. The issue is whether or not the new service rates are hindering potential competition or are excessive to the end user. The fact that the revenue to the LEC is de minimis is not relevant for determining if the new service rates are predatory or excessive.

USTA and JSI's proposal attempts to misuse the de minimis provision. The de minimis provision was created because conducting a cost of service study on a new service is difficult and the results, given no direct information on costs, may not be very reliable. Therefore, the Commission established the de minimis rule as a benchmark because of the limited value of potentially inaccurate cost of service studies and determined it is reasonable not to delay the release of new innovations into the marketplace. The Commission also determined that one year's experience was sufficient time to calculate a reliable cost of service study, using direct information, and therefore required Price Cap LECs to [re]set the rates for the new service to reflect its costs after this one year period.

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15 Notice, ¶ 16.

16 USTA, p. 19, JSI, p. 7.

USTA implies that a potential evil of cost-based pricing of a new service after one year is that it could actually cause rates to increase and produce rate churn.[17] MCI submits that if this occurs it is not an evil but a good.

If in fact after one year the LEC finds that the true cost of the new service is drastically different than the rates it is charging, then we will have already incurred one year of inefficiencies in this market. There is no reason to perpetuate these inefficiencies. In MCI's view, the sooner the rates can be set to reflect their underlying costs the better. Therefore, the rates for new services should be set to reflect actual costs as soon as possible and the Commission's proposal of a one year time frame of experience appears reasonable.

5. Initial New Service Rates Could Be Presumed Reasonable If They are Less Than the Industry Average

Along with the de minimis provision, the Commission has proposed a second provision which must be met for the rates for new services to be presumed lawful. This second provision is the establishment of a benchmark. The Commission proposed that as long the new service rates of a OIR LEC are less than its neighboring Price Cap LECs, the rates would be presumed lawful. Certain Commentors have argued against this Commission proposal.[18] Some Commentors have supported the FCC proposal.[19] As

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17 USTA, p. 19.

18 USTA, p. 22, NTCA, p. 8, Taconic, p. 5, CBTC, p. 14, PRTC, p. 8, Alltel, p. 6, SBA, p. 23, and NECA, p. 11. GVNW argues that the rates should be presumed lawful if they are less the NECA or the geographically closest Price Cap LEC, p. 7.

19 Centel, Lincoln and TCA, p. 13.

stated in MCI's Petition for Partial Reconsideration filed in the ONA proceeding, MCI believes the rates for all new services should be cost based.[20]

All of the commentors who oppose the Commission proposed benchmark use different words to argue their position, but upon close examination of their arguments it is clear that they are requesting that the rates for a new service should be presumed lawful as long as they are not the highest in the industry. The Commission chose the rate of the closest geographically located Price Cap LECs as a benchmark because it is probable the OIR cost structure will be similar to the cost structure of its geographically closest Price Cap LECs. The cost structure for the LEC with the highest nationwide rate for the new service may not in any way reflect the cost structure of the OIR LECs. Therefore, the Commentors solicitation to set the benchmark of presumed lawfulness for new services at the highest existing rates is certainly an unreasonable request.

MCI submits that an interim alternative approach to streamlining new service regulation for OIR LECs could be to presume rates for new services lawful as long as they are below the tariffed industry average.[21] This interim approach could be used until guidelines are developed that facilitate accurate cost based pricing of new services. MCI submits that the use of an average may be superior than the "closest geographically located" approach and it also incorporates some of the concerns voiced by commentors

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[20] In the Matter of: Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, CC Docket No. 89-79, and Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, MCI Petition for Partial Reconsideration, filed September 21, 1992.

[21] If the service is not currently tariffed by more than one LEC, the rates for the new service should be cost justified.

in this proceeding, because this approach accounts for more diverse demographics and other factors that effect costs.

6. The Service Quality Reporting Requirements Are Unduly Burdensome

Many of the Commentors suggest that the proposed OIR reporting requirements are excessive and should be reduced.[22] The general consensus is that the quarterly report should instead be annual. MCI does not object to this modification.

B. Baseline Rate-of-Return Regulation

1. Prospective versus Historical Ratemaking Cannot Be Optional

The Commission has proposed that projected costs and demand data may be developed as simple extrapolations of historical costs and demand.[23] Comments were filed on this proposal by many parties requesting that this provision be made optional.[24] MCI opposes this request.

MCI maintains that the rates for a new service should be determined using Total Service Long Run Incremental Cost (TS LRIC) prospective forecasting.[25] Moreover, provided that adequate earning review and refund mechanisms exist, what matters is

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[22] USTA, p. 23, GVNW, p. 4, Alltel, p. 6, JSI, p. 8, Centel, p. 9.

[23] Notice, ¶ 35.

[24] GVNW, p. 6, CBTC, p. 16, Lincoln, p. 8, PRTC, p. 9, TCA, p. 12, USTA, p. 34, Centel, p. 11, ITAG, p. 10 and JSI, p. 14.

[25] *In the Matter of Transport Rate Structure and Pricing, CC Docket No. 91-213, Comments of MCI* Telecommunications, November 22, 1991, p. 18.

consistency. A rate of return LEC must not be given a choice of alternative methods by which to calculate rates. This choice will only serve to ensure the highest rates are imposed and excessive rates are charged to the end user in the long run. For example, if the LEC is given two alternative methods to calculate rates, it will naturally choose the method which permits it to make the most money. The LEC can do this because it knows that next year, if the other method produces better results, it can just choose the other method. Providing alternative methods to calculate rates almost guarantees that short run aberrations will never be recovered and long run rates charged to end users will be excessive. Therefore, the Commission should not change its proposal and must not make historical forecasting optional.

2. Certain LECs have Inappropriately Argued for an Increase Rate of Return Buffer Zone

The Commission declared that enforcement issues generally should be addressed in CC Docket No. 92-113 and only solicited comments on sharing in this proceeding.[26] Never-the-less, certain LECs found it necessary to comment on rate of return issues. USTA and Centel have inappropriately argued in this proceeding for an increased rate of return Buffer zone.[27] These arguments should be summarily dismissed and if USTA and Centel wish to raise these issues in the appropriate proceeding they should be addressed at that time.

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[26] Notice, footnote 11.

[27] USTA, p. 34, Centel, p. 14.

III. CONCLUSION

As shown by MCI, the Commission's OIR plan and streamlined rate of return regulation for non-price cap LECs does not contain insurmountable problems. However, the requests made by certain commentors in this proceeding are unreasonable and should not be adopted.

Respectfully submitted,

MCI TELECOMMUNICATIONS CORPORATION

Gregory J. Darnell
Manager, Regulatory Analysis
1801 Pennsylvania Ave, NW
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(202) 887-3290

Dated: September 28, 1992

STATEMENT OF VERIFICATION

I have read the foregoing, and to the best of my knowledge, information, and belief there is good ground to support it, and that it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on September 28, 1992.

Gregory J. Darnell
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CERTIFICATE OF SERVICE

I, Carolyn McTaw do hereby certify that copies of the foregoing MCI petition were sent via first class mail, postage paid, to the following on this 28th day of September, 1992:

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